November 7, 2011

The Honorable Max Baucus
Chairman
Senate Finance Committee
511 Hart Office Building
Washington, DC 20510

The Honorable Dave Camp
Chairman
Committee on Ways and Means
341 Cannon Office Building
Washington, DC 20515

The Honorable Orrin Hatch
Ranking Member
Senate Finance Committee
104 Hart Office Building
Washington, DC 20510

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
1236 Longworth Office Building
Washington, DC 20515

Dear Chairmen Baucus and Camp and Ranking Members Hatch and Levin:

We are writing as a group of academic and consulting economists who believe that the U.S. corporate income tax rate should be reduced from its current 35 percent level to one that is competitive with the rates in almost all other major industrial countries. Both the National Commission on Fiscal Responsibility and Reform and the Debt Reduction Task Force of the Bipartisan Policy Center advocated a broadening of the corporate tax base by reducing marginal rates and by eliminating business tax expenditures. Such a move would likely lead to a more efficient allocation of resources, increased investment and employment in the United States, and higher wages. While some of the forgone revenues would be paid for by an expansion of the tax base, in light of the fiscal challenges faced by the U.S. government, all current exemptions to the corporate income tax should be revisited with the aim of achieving revenue-neutrality. Economists recognize that reducing corporate tax rates can eliminate distortions to economic activity, such as locating a business abroad for tax reasons. In contrast, closing tax loopholes, which do not likely affect business decisions at the margin, can reduce tax avoidance, and thereby generate a broader tax base and more revenue for a given corporate tax rate.

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The United States has the highest national statutory corporate tax rate among the 34 members of the OECD. Its rate is nearly ten percentage points greater than the average OECD rate of 25.5 percent. When state taxes are included, the United States has the second-highest statutory combined corporate tax rate (39.2 percent) after Japan (39.5 percent). Given the double taxation of corporate profits in the United States, the overall tax rate is even higher. According to Ernst & Young (2011), the overall top rate on corporate earnings paid out as dividends is 50.8 percent, and the overall top rate on corporate earnings that are retained is 42.1 percent.

As explained below, a high corporate tax rate (1) impairs our ability to attract domestic and foreign investment, (2) undermines job creation and reduces wages, (3) distorts financial and economic decision making by U.S. firms, and (4) spawns inefficient government programs and policies. Reducing the corporate tax rate would improve the allocation of resources throughout the economy and would increase productivity and living standards.

A high corporate tax rate impairs our ability to attract domestic and foreign investment. Because capital and information flows more freely across borders in the Internet age, disparities in the corporate income tax rate can now have a greater impact on location decisions than in the past. The number of Fortune Global 500 headquarters in the United States decreased from 179 to 133 from 2000 to 2011, while China (25.0 percent tax rate), Switzerland (21.2 percent tax rate), and Korea (24.3 percent tax rate) experienced sizable increases over the same period. De Mooij and Ederveen (2005) found that a one percentage point reduction in a host country's tax rate increased foreign direct investment by 2.9 percent. The OECD (2011) found that corporate income taxes, of all the different types of taxes, are most harmful to economic growth and capital accumulation.

A high corporate tax rate undermines job creation and reduces wages. According to the Commerce Department, foreign investment supported five million U.S. jobs in 2010. To the extent that our relatively high corporate tax rate discourages foreign investment, it discourages job formation. Moreover, several academic studies have found that much of the burden of the corporate income tax is borne not by capital but by domestic labor, in the form of lower wages. For example, Mathur and Hassett (2010) analyze the relationship between corporate tax rates and the average manufacturing wage for 65 countries over a period spanning 1981–2005; they estimate that a one percent increase in the corporate income tax leads to a one half of one percent decrease in hourly wages. The U.S. Treasury Department assumes that 25 percent of the incidence of corporate tax is borne by workers.

A high corporate tax rate distorts the financial and economic behavior of U.S. firms. Because payments on debt are tax deductible, and dividends are not, companies have a strong incentive to use debt rather than equity finance under the current regime. The Treasury Department (2005) estimated that the marginal effective tax rate for an equity-financed investment in the corporate sector was 39.7 percent, while the rate for a debt-financed investment was -2.2 percent. This is not to say that all debt financing is bad (although excessive debt increases the risk of bankruptcy); rather, firms should be making debt-equity capital decisions that are based on considerations other than their tax-cost implications. A high corporate tax rate also encourages firms to waste resources on tax avoidance; e.g. large corporations can transform their income into more tax-preferred forms by hiring more tax attorneys. To avoid lower returns on their investments, U.S. firms devote substantial resources in rent-seeking activities, and politicians often reward favored constituent businesses by creating exemptions to the code.

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For the foregoing reasons, we recommend a reduction in the U.S. corporate income tax rate. Concurrently, policymakers should seek to eliminate exemptions to the tax rate to ensure that the reduction in rates is budget-neutral.

Sincerely,

Brian Becker, Precision Economics

Charles Calomiris, Columbia University

Robert Crandall, Brookings Institution

Michael Crew, Rutgers University

Jeffrey Eisenach, George Mason University

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